RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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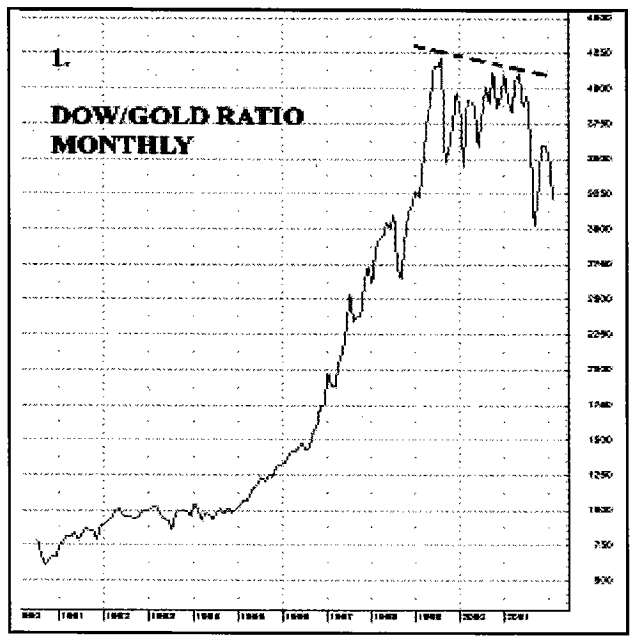
LETTER 1331

February 13, 2002

January 25, DJIA 9840.08; PTI 5338; A-D Ratio - .21
February 1, DJIA 9907.26; PTI 5339; A-D Ratio +.07
February 8, DJIA 9744.24; PTI 5324; A-D Ratio -.56
Dow Yield: 1.87 % Dow p/e: 26.53
Gold 50-day MA: $281.00

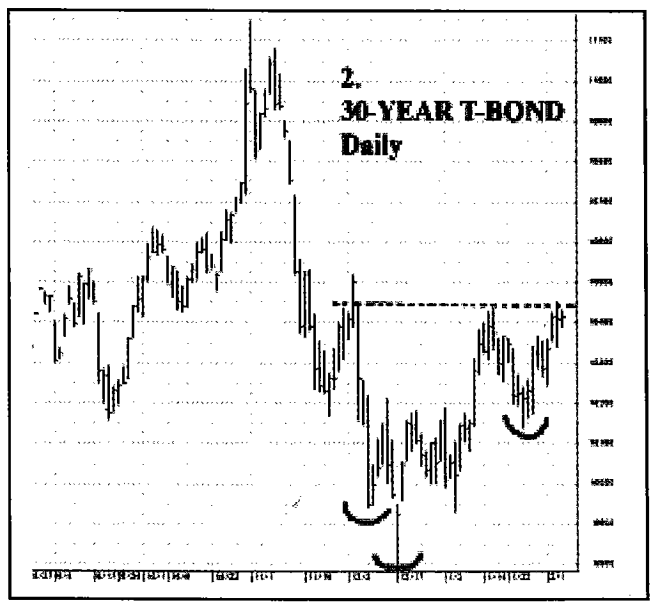
PICTURES – I want to start this Letter with a few charts. The first chart is very interesting and probably surprising. It's a monthly chart showing the ratio of the Dow to gold. I don't think many people realize this but **since August of 1999 gold has been outperforming the Dow.**



The interesting thing is that from 1990 to 1999 this ratio rose as a parabolic curve. Old timers know that when parabolic rises top out, they top out for a LONG time. Further, they often decline to the point where they first began. Thus, it seems to me that we face a long period in which gold is fated (irregularly, of course) to outperform the Dow.

Back in 1980 the Dow would buy roughly one ounce of gold. At its 1999 ratio high the Dow would buy 42 ounces of gold. Today the Dow will buy about 34 ounces of gold. My prediction – we'll see the time when the price of the Dow will be below the price of gold, and the Dow once again will buy one ounce or less of gold.

The second chart is a daily chart of the March 30-year T-bond. What this chart is "saying" is not what you hear from your local broker. What we see here is an impressive bottom formation in the long-term bond, suggesting accumulation and gathering strength.

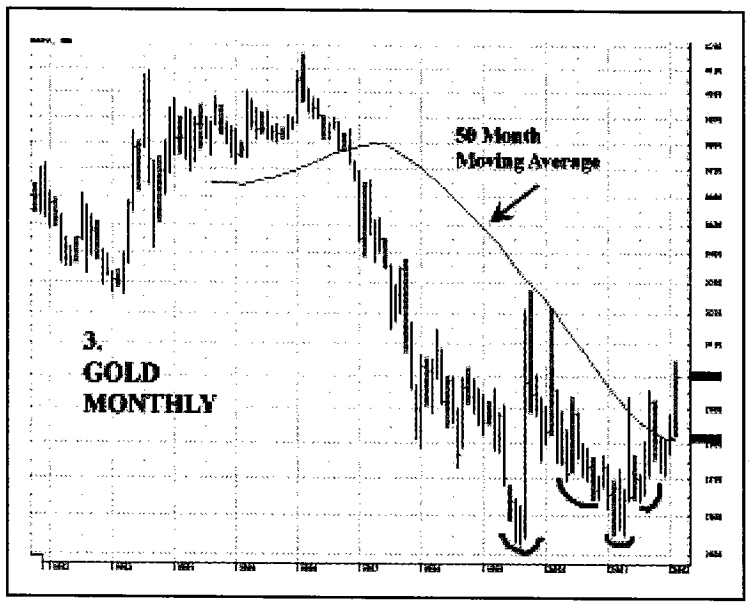


What's the meaning of strength in the 30-year T-Bond? I think the chart is saying that we're in for a long period of stagnation or recession, and because of very weak pricing-power, there's little fear of inflation among bond people.

There's another factor worth considering. Bonds (unlike stocks today) provide real income. At 5.4% free of state taxes, serious, seasoned investors are buying long Treasury bonds for income as well as safety of principle. Nothing wrong with that.

The third chart is a monthly chart of gold with a 50-month moving average. Here we see gold basing in what appears to be a massive

head-and-shoulders bottoming formation, a bottom that has been formed over a period of two years or more.



For the first time since October of 1996 gold has now climbed completely above its 50-month moving average. If gold is starting a new bull market (and I believe it is), this chart suggests that the bull market is just getting started. A major upside breakout would come if gold can close above its 296 peak of September 21, 2000. An even better indication would be if gold could close above 300.

Question: Is it possible for both bonds and stocks to rise together? **Answer:** Normally, no, but these are not normal times. People are buying bonds because they provide safe income, while most stocks are not only declining but they provide no income. At the same time, people are buying gold because gold is real money -outside the Federal Reserve system. And remember, stocks are denominated in dollars, and the way to diversify out of dollars is either in yen (backed by a shaky economy) or euros (which are a new and untested currency). Gold has been around and accepted as real money for 5,000 years. That's a bit longer than the central banks have existed.

THE PICTURE – Question - If the stock market discounts all known information, then why do we spend so much of our time reading the *Wall Street Journal* and *Forbes* magazine and watching CNBC? Instead, why don't we spend 90% of our time studying the stock market itself?

Answer: Ah, good question, fundamental question, logical question. And the answers are obvious: (1) Most people don't believe that the stock market discounts everything, and (2) most people don't believe that all the information that anyone knows sifts down to the movements of the stock market. Even if they did believe number one, they still don't know how to "read" the stock market.

The stock market has its own language, and that language tends to be disguised. Worse, that disguise runs counter to our emotions. In a word, it's counter-intuitive.

Counter-intuitive? Yes, when everything looks perfect and the sky is blue and there's not a cloud in sight, that is when we're most likely to receive a Dow Theory bear signal. But ironically, that's also the time when a bear signal is least likely to be believed.

Conversely, when stocks are down and blue chips offer great values, when the economy is flat on its back, when investors are depressed and cursing Wall Street, that's about the time when we can expect a Dow Theory bull signal. Again, ironically, that is also the time when a bull signal is least likely to be believed.

And we have to ask why? Why the deceit? The answer is that 90% of all decisions made by human beings are made on the **basis of emotions** rather than on intellectual decisions. Obviously, it's easier to buy stocks when business is great. Obviously, it's easier to avoid stocks when business is terrible and stocks are at their lows.

It's been said that nothing that man has ever created is as frustrating as the stock market. Why is this? The reason is that big money ultimately controls the market and big money understands **values.** And big money likes to move in secrecy. Have

you ever heard a major investor announcing that he is distributing his shares? Hardly, more likely the same major investor is telling some newspaper reporter that the market never looked better. It's human nature. Why would you want to wreck a market when you're trying to get rid of some of your stocks?

Repeat that same set of circumstances over a thousand cases, and you can see why markets tend to destroy the average investor. The average investor is an amateur playing against professionals. Of course, the average investor will occasionally win. Of course, the amateur gambler in Las Vegas will occasionally win. But on balance, the amateur is fated to lose. That's the way the game is played. Professionals win, which is why they're professionals, and amateurs lose, that's why they're amateurs.

Today it's said that over 60% of American families have some kind of stake in the stock market. This is not a healthy situation. It's not healthy because in the end these people are going to lose money. In fact, my guess is that the average US investor is already losing money. And my firm belief is that the average US investor is fated to lose a lot more money as this bear market moves on.

Much of what I write is dedicated to helping the average investor. It's interesting, however, that an increasing percentage of my subscribers tend to be business people, professionals, fund managers, bankers and wealthy investors. I'm not sure exactly why this is – I suspect that there are two answers — (1) If a wealthy investor or a professional gets one good idea or perspective a year out of my work, the price of a subscription is worth it to him. And (2) I admit it; I'm a pretty fair writer. So subscribers may simply like to read what I have to say. After all, when you've been doing what I do for half a century, it's only natural that you'd have something worth saying (maybe not every day, but hopefully a lot of the time).

What I started to say (and I'm finally getting around to it) is that aside from all the talking and news items and observations, what I feel that I offer is my ability to understand what the market is saying. I believe I'm fairly good at reading the "secret language" of the stock market.

The truth is that I probably should be writing strictly technical stuff about the market while leaving out all the items that you can read every day in the *Wall Street Journal* or the *New York Times*. But I also want to make my reports interesting, and writing strict tomes on the internal structure of the stock market would be a bit dry. So I add whatever writing skill I have to the reports, and well, that's what I offer.

Milton Friedman, a Nobel Laureate, wrote a most interesting column that appeared on the OP/Ed section of the *Wall Street Journal* (January 22). In his column Friedman compares three historic bull market booms that ran into trouble. He's talking about the 1921-1929 boom, the boom in Japan that ended in 1989, and the current situation.

Friedman writes, "The three bull markets in stocks likewise display remarkable similarity, even extending to the early stages of the current (US) decline. In the six years prior to the stock market peaks, the indexes rose 333% in the US from 1923 to 1929, 387% in Japan from 1983 to 1989 and 320% in the US from 1994 to 2000."

Then Friedman turns to the money supply. "The behavior in the following years differed much more sharply. The US quantity of money fell by more than a third from the cyclical peak in 1929 to the trough in 1933. The Japanese quantity of money fell by two-thirds of one percent in the first year after the cyclical peak, and then rose by 2.5% per year in the next two years. In the current episode, the quantity of money in the US has already risen by more than 11% during the first five quarters after the cyclical peak."

Friedman then states that these differences were the reason why the US suffered so much more in the bear market than did Japan. Then he adds, "They also suggest that the current reaction in the US will be far less severe than in either of the earlier episodes . . .. Every great depression has been accompanied or preceded by sharp increases in the quantity of money."

Friedman adds that Central bankers have learned a lot about money, which is why there has been "no Great Depression in the post-World War II period despite repeated scares. The Federal Reserve under Alan Greenspan is currently applying that lesson, which is reason to believe that the current recession will be mild and that expansion will soon resume."

At the end of his article, Friedman warns, "While the current rate of monetary growth of more than 10% is sustainable and perhaps even desirable . . . continuation of anything like that rate of monetary growth will ensure that inflation rears its ugly head again."

Russell Comment: Few will argue with any of the above. This is the monetarist viewpoint and few analysts today would disagree with it. In fact, the Fed's actions are the main reason why the majority of analysts and money managers remain bullish today. But in this business nothing is easy, nothing is automatic, nothing is a given.

There's always something different added to the market mix. For instance, what Friedman doesn't talk about is the current levels of debt. Corporate debt has risen to record levels, whether in relation to profits or GDP. In the consumer sector, the relation of consumer debt to income is now 18.9%, the highest ratio in history.

I have to believe that Greenspan is aware of the debt problem. So what's the prescription to fighting the peril of debt? The prescription is inflation, and rising levels of activity. This is the reason why the Fed has embarked on the greatest surge of liquidity and declining rates in its history. Declining rates make it easier to carry debts and declining rates may move consumers to spend. And the huge infusions of bank credit set off by the Fed mean that the banks have the money to lend.

The one thing the Fed is mortally afraid of is a cutback in consumer spending and a move towards savings. The Fed cannot allow that to happen. This is the reason why almost every other day we hear some Fed governor announce that "the worst may be over." They want to inspire consumer confidence; they want consumers to continue to spend and by tacit admission, to take on even more debt.

This is where the stock market comes in. The stock market is, I believe, the current KEY to consumer confidence. As long as the Dow holds in the general area of 9000 to 10000, consumers will believe that "everything's all right." But if the stock market starts sagging, if the stock market breaks below 9000, consumer confidence will turn to consternation, even fear, and the Fed "cannot allow that."

I believe this bear market is in its second psychological phase. In this phase, we'll see consumers gradually, very gradually, believe that this is, indeed, a bear market. Remember that the current generation has grown up in an 18-year bull market. They grew up "buying the dip" and believing that the market would push ever higher. They don't have any idea of what a primary bear market looks like.

But through it all, sentiment could be changing. Consumers may remain bullish, but it's what they do with their money that counts. For instance, last year mutual funds took in a net $32.3 billion. But that was a drop of 90% from the $309 billion that mutual funds took in 2000. And last December the funds took in a net $3 billion, down from $15.3 billion in November.

I believe that the next phase of the mutual fund cycle will see a net outflow of money from the funds. If this happens, it will put steady pressure on the stock market as American stockholders begin to redeem their money and as the thousands of mutual funds are forced to sell in order to raise cash.

I've often stated that the average investor relates to the Dow. Ask him where the S&P or the Wilshire 5000 or the NYSE Index is and you'll draw a blank. But ask him where the Dow is and he'll at least tell you that it's "over 10000" or "around 9000."

Earlier in this primary bear market I posted what I called my "Top-Out Parade." This was a list of important stock market averages and indices that had recorded highs. I listed these various items to show or prove to subscribers that the bull market was over, and that a bear market had taken its place. I'm going to repeat my Top-Out Parade below. It's interesting (and I believe very significant) that none of these items has been surpassed.

TOP OUTS

Daily new highs on the NYSE topped out at 631 on October 3, 1997.
The advance-decline ratio for the NYSE topped out April 3, 1998 at 13.00.
The Value Line (geometric) Average topped out April 22, 1998 at 508.39.
The Morgan Stanley Cyclical Index (index of cyclical stocks) topped out May 10, 1999 at 619.09.
The D-J Transportation Average topped out May 12, 1999 at 3783.50.
The D-J Industrial Average topped out January 14, 2000 at 11722.98.
NYSE Margin accounts (the level) topped out in March at $278.5 billion.
The Russell 2000 Average (lower priced stocks) topped out March 9, 2000 at 606.12.
The Nasdaq Composite topped out March 10, 2000 at 5048.62
The Amex Index topped out March 23, 2000 at 1036.40.
The Wilshire 5000 topped out March 24, 2000 at 14751.64.
The S&P topped out March 24, 2000 at 1527.46.
The NYSE Composite Average (all NYSE stocks) may have topped out Sept 1, 2000, at 677.58.
The D-J Utility Average topped out December 26, 2000 at 416.11.
The NYSE Financial Average (banks, S&Ls, brokers, loan companies) may have topped out on January 3, 2001 at 657.52.

INVESTMENT POSITION –The bear remains in the box, meaning that this continues to be a bear market.

What to do? If you're in doubt, move into T-bills. That's the easiest position. But T-bills (they're free of state taxes) don't pay much. You might go out 5 years and buy T-notes that will yield over 4%. Nothing wrong with that. Or you might buy municipal bonds maturing in five or six years. They're tax free from your state, and top-grade munis almost never default.

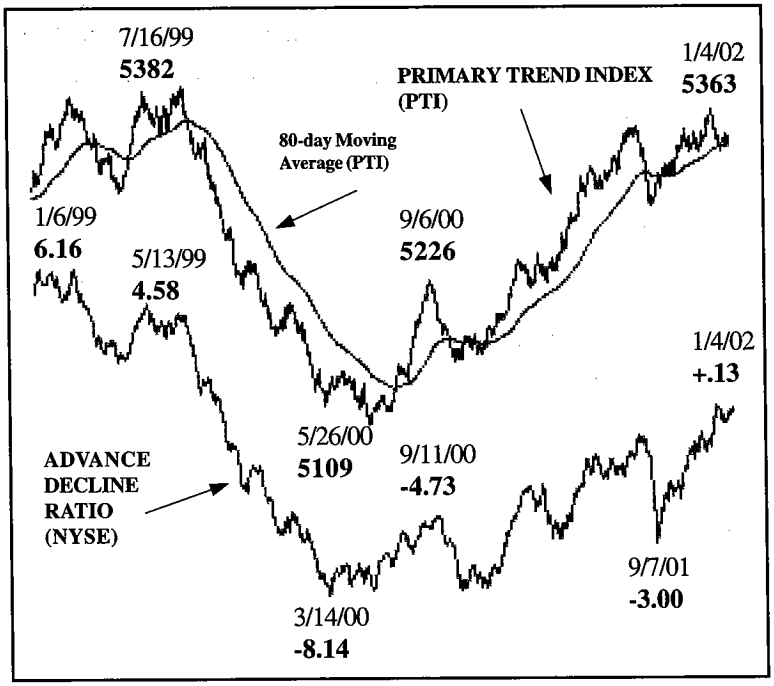
You might also buy a handful of gold stocks, just in case people decide that they want real money instead of government manufactured paper money. In that case you might buy some NEM, PDG, ABX or AU, take your choice. I don't know which will be the best performer, so it's better to buy two or three.

Best in a bear market to keep it simple. I don't know how to keep it any simpler than the way I describe it above.

NOTE – I've written a lot in this Letter, and I'm forced to place my PTI chart on page 6.

NOTES & QUOTES: I hate to say it, but I'm "turning off" on professional sports. So, it seems, are a lot of other people. First of all, there are just too many sports on TV. Every few months or so they develop a new sport. The only sport that isn't featured on TV is the most popular sport in the world, soccer. Americans never developed a love for soccer. That could be changing – a little.

But check out these facts. Attendance last year fell for 60% of Major League Baseball franchises. This widened the gap



between baseball's haves and have-nots. Even all the new stadiums didn't help.

The major TV stations, which paid huge bucks for the rights to televise major sports, have suffered huge losses on their deals amid the worst advertising market since World War II. According to industry estimates, the three networks collectively will lose over a billion dollars on Major League Baseball, the NBA, the NFL and NASCAR.

Nearly half the 117 schools in NCA Division I lost money on their athletic programs last year. A number of schools have dropped the most expensive sport, football.

The market for expensive stadium-naming deals has just about collapsed, drying up an easy source of cash for team owners. Ratings for Monday Night Football fell 24% among all viewers over the last ten years. Ratings for the latest Super Bowl were down.

What's the answer? Like so many other things, sports viewing has become almost a bubble. Too many sports. Too much of sports have just turned into a business. Free agency has messed up some sports. The fans are just growing bored. Finally, the cost of going to a sports event has become almost ridiculous. It's easier and a damn sight cheaper to stay home and watch your favorite team on TV. But even here, viewership is dropping off. I know I personally do a lot less sports-viewing than I used to. And as far as dreaming of owning a professional sports team, I just never had that dream.

* * * * * *

What's the oldest living thing? No, it's not your editor; it is probably a creosote bush located in Palm Springs, California. Radiocarbon tests underway reveal that this bush sprouted 11,000 years or more ago. Seemingly more dead than alive, the bush isn't big and it isn't tall. In a species that reproduces itself by cloning — any individual is theoretically as old as the species.

CHART BOOKS AND CHART PAGES 2001. Don't ask me why but in an industry that involves trillions of dollars, nobody else does this. What I'm talking about is chart books of the **D-J Averages** and the all-important **breadth index** (i.e. advance-decline ratio). I've been offering these two chart albums for decades, and I feel they're invaluable. Actually, I started these albums back in the '60s because I needed the data myself. The first volume is a **complete daily history** of the D-J Averages (all three Averages plus bonds and volume) going back to **1885**. Important economic and world events are noted on each page. The charts are packed in a big three-ring, hard cover binder, one page for each year. The album is yours for $140; we pay the postage in the States.

The second album covers the Dow and the extremely important **A-D ratio** (daily) going back to 1931. Comments regarding the action are included in many of the pages (one page for each year). The price is $100, we pay US postage.

For those who own the chart books, the new 2001 pages are ready, and the price is $5 for the page of the D-J Averages and $5 for the new A-D ratio page. Please send your money in now (outside the States there's an extra postage charge of $35 for each album). Write to Dow Theory Letters, PO Box 1759, La Jolla CA 92038.

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